

D. UPDATE ON HEALTH CARE JOINT VENTURE ARRANGEMENTS

by
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1. Introduction

The 1999 CPE discussed whole hospital joint ventures and the impact of Rev. Rul. 98-15 on such arrangements. This section will update and expand on the 1999 CPE discussion.

2. Rev. Rul. 98-15

Rev. Rul. 98-15, 1998-12 I.R.B. 6, was released on March 4, 1998. It provides guidance on the tax treatment of exempt hospitals participating in whole hospital joint ventures with for-profit entities. The ruling addresses the issue of whether a tax-exempt organization operating an acute care hospital may retain its tax exempt status when it forms a limited liability company (LLC) with a for-profit corporation and then contributes its hospital and all of its related operating assets to the LLC, which then operates the hospital.

Rev. Rul. 98-15 analyzes two fact patterns involving whole hospital joint ventures, one of which was permissible and one of which resulted in revocation of the tax exempt status of the exempt participant.

A. Comparison of Situation 1 and Situation 2

In Situation 1, the revenue ruling concludes that the hospital continues to operate exclusively for charitable purposes and only incidentally to further the private interests of the for-profit. As a result, it retains its IRC 501(c)(3) exempt status. The hospital in Situation 2, however, fails to establish that it will operate exclusively for charitable purposes after it contributes its assets. Therefore, its exemption is lost.

Some similarities exist in the factual descriptions of the two scenarios. In both, a nonprofit hospital in need of more funds forms a limited liability company ("LLC") with a for-profit corporation. In each situation, the nonprofit contributes its hospital and other operating assets to the LLC, which then operates the hospital. Each LLC is structured so that it will be treated as a partnership for federal income tax purposes. In each, the exempt organization and the for-profit entity receive ownership interests in the LLC that are proportional and equal in value to their respective contributions. All returns of capital and distributions of earnings made to the members of the LLC are proportional to their ownership interests. Each nonprofit intends to use the distributions it receives from the LLC to fund grants to support activities that promote the health of the community.

However, in all other aspects, the two arrangements are quite dissimilar. In Situation 1, three of the five members of the LLC's governing board are chosen by the tax exempt hospital, and two are chosen by the for-profit corporation. A majority of three members of the board must approve certain major decisions relating to the LLC's operations. Nothing is stated in the revenue ruling regarding quorum requirements, because by having a majority representation on the governing board, the exempt hospital will be able to act unilaterally with regard to matters, irrespective of quorum requirements.

Major decisions in Situation 1 include:

- LLC's annual capital and operating budgets;
- distribution of LLC's earnings;
- selection of key executives;
- acquisition or disposition of health care facilities;
- contracts in excess of \$x per year (i.e, a specific dollar amount threshold);
- changes to the types of services offered by the hospital; and
- renewal or termination of management agreements.

The governing documents require that the LLC operate all of its hospitals (including any hospital contributed by the for-profit) in a manner that furthers charitable purposes by promoting the health of a broad cross section of the community. The governing documents also explicitly provide that the duty of the LLC directors to operate the LLC in a manner that furthers charitable purposes overrides any duty they may have to operate the LLC for the financial benefit of its members (the owners of the LLC). Therefore, if there is a conflict between operating under the community benefit standard and maximizing profits, the directors are required to follow the community benefit standard without regard to the consequences to profitability. An important factor is that the terms of the governing documents are legal, binding and enforceable under applicable state law. Thus, acting in furtherance of the nonprofit's interest will not conflict with any fiduciary duty by the directors to the LLC. Moreover, should any conflict require arbitration or other litigation, there is no question as to where the fiduciary duty of the directors lies.

The LLC enters into a management agreement with a management company that is unrelated to either member of the LLC. It provides the day to day management services to the LLC. Implied in the factual situation is that a management agreement with a nonprofit affiliate of the exempt hospital would also be permissible. The management agreement is for a definite term of five years, renewable for additional five year periods by mutual consent and terminable by the LLC for cause. Fees are based on gross revenues. The term, fee and conditions of the management agreement are reasonable and comparable to management contracts of other firms for similar services at similarly situated hospitals.

Also, there are no conflicts of interest or possible "sweetheart" deals. None of the

officers, directors, or key employees of the nonprofit who were involved in decision-making or the negotiations involving the formation of the LLC were promised employment or any other inducement by the for-profit, the LLC, or their related entities. In addition, none of these individuals have any interest, directly or indirectly, in the for-profit or any of its related entities.

In contrast, in Situation 2, each member of the LLC is authorized to select three representatives to the governing board. A majority of the directors is required to approve certain major decisions relating to the LLC's operation. Thus, in Situation 2 decisions with regard to major matters requires a consensus in order to form the necessary majority. Thus, the nonprofit hospital has at best a veto power only without any affirmative authority. In Situation 2, the reserved powers are more limited in scope, and include:

- LLC's annual capital and operating budgets;
- distributions of LLC's earnings over a required minimum level specified in the operating agreement;
- "unusually large contracts"; and
- selection of key executives.

In Situation 2, the governing documents of the LLC provide that its purpose is to construct, develop, own, manage, operate, and take other action in connection with operating the health care facilities it owns and engage in other health care related activities. There is no reference to charitable activities among the purposes stated for this LLC.

The management company is related to the for-profit member. The management agreement is for an initial five year period, but is renewable for additional five year periods at the sole discretion of the manager, and can be terminated only for cause. The chief executive officer ("CEO") and chief financial officer ("CFO") have previously worked for the for-profit in hospital management and together with the management company they will oversee the day to day management of the LLC.

B. Significance of the factual differences in Situation 1 and Situation 2

The ruling requires a factual determination. Emphasis should be directed to the board composition and to operation, including such areas as the structural and financial arrangements; who actually makes the recommendations for decisions that come before the board; nature of the contractual arrangements; and how the governing board of the joint venture is selected. These elements are helpful when looking at the closures of hospitals or facilities, or cessation of certain services, as well as other resulting effects.

Thus, in Situation 1, the right of the for-profit member of the LLC to receive distributions is, in effect, subordinated to the right of the exempt hospital to approve or disapprove distributions. The rights with respect to distributions in Situation 2, in contrast, are subject to a governance structure that could result in deadlocks due to the equal powers of the two members. Without an explicit statement in the governing documents that charitable purposes take precedence over any profit motive, any such conflict could result in a finding that the fiduciary duty of the directors are to maximize profits.

The LLC in Situation 2 enters into a long-term management agreement with a wholly-owned subsidiary of the for-profit member to provide the day to day management services to the LLC. It is essentially a perpetual contract in that, although it is for an initial term of five years, it is renewable for additional five year periods at the discretion of the manager. The LLC may terminate the contract only for cause. The Chief Executive Officer and Chief Financial Officer of the LLC previously worked for the for-profit.

The factors listed in Situation 1 are indicative of a proactive and involved board as opposed to one that may be more hands-off. The exempt hospital not only has more board members and control over policy decisions, it also has a strong operational authority. In other words, it has *effective* control over the whole decision-making process. The facts in Situation 1 also make it clear that evidence of community benefit, such as a strong charity care program or other signs of furthering the health of the community, is essential.

C. Is it possible to reform Situation 2?

It would be difficult, if not impossible, to discuss what changes, if any, could be made to Situation 2 so that the LLC described would not jeopardize the nonprofit hospital's exemption. Rev. Rul. 98-15 makes it clear that the analysis is a facts and circumstances test. It is not feasible to identify any one factor as determinative or critical. Changing the fact pattern only slightly, such as requiring a set term for renewals, with the decision resting with the exempt hospital, is not enough. Such an arrangement would not address concerns regarding the management company's authority to control the dollar amount of its compensation and issues that are brought before the board. Similarly, requiring the manager in Situation 2 to operate within certain community benefit parameters still does not lessen the impact of the management company's link to one of the investors in the LLC and where the control would lie in the overall LLC arrangement. The terms of the management contract and operational conditions that are very general, such as open emergency room, some of which actually come down to simply agreeing to comply with existing federal and state law, are not enough to make it a favorable situation.

The exempt hospital in Situation 2 jeopardizes its exemption based on all the facts and circumstances of its joint venture arrangement.

In Situation 2, the control over hospital operations has substantially shifted to the for-profit. There is no binding obligation in the LLC's governing documents for the LLC to serve charitable purposes or otherwise provide health care services to the community as a whole. The nonprofit will not have voting control of the LLC board.

However, the lack of structural control is further exacerbated by the contractual control vested in the for-profit or its affiliate. Although the management fee is reasonable, the perpetual duration of the management arrangement makes the arrangement in essence a non-arm's length contract by virtue of ceding control over renewals to the for-profit as long as it does not breach the agreement. The management company itself will have broad discretion over the LLC's activities and assets and may not always be operating under the supervision of the LLC board. For example, the management company could enter into all but "unusually large" contracts without board approval and it may unilaterally renew the management agreement.

Similarly, even though the compensation for the LLC's CEO and CFO is reasonable, their prior relationship with the for-profit and its management company places them in an apparent conflicts of interest situation. The primary source of information for the LLC board members appointed by the nonprofit would be these executives.

D. Use of the LLC in Rev. Rul. 98-15

The examples in Rev. Rul. 98-15 use a limited liability company as the entity through which the joint venture is conducted. There is no factual significance in the fact that an LLC is the joint venture arrangement rather than a limited partnership or general partnership. Rather, the LLC joint venture arrangement was chosen due to the overwhelming use of the LLC in most whole hospital joint ventures. Also, it was a conscious effort on the part of the Service to bring into focus a relatively unknown kind of arrangement that in and of itself does not cause problems, so long as it is deemed a partnership for tax purposes.

E. Public Charity Status

Rev. Rul. 98-15 resolves the question of public charity status by applying the theory of partnership taxation to exempt organizations. Rev. Rul. 98-15 makes it clear that it is possible to enter into a joint venture arrangement and qualify for public charity status due to the passthrough analysis. If the joint venture arrangement allows the exempt participant to further charitable purposes and does not result in more than incidental private benefit to for-profit entities, the next consideration is the public charity classification. In Situation 1 of Rev. Rul. 98-15, the exempt organization carried out its principal activity, the operation of a hospital, through the LLC. Thus, the public charity classification of the exempt LLC member continues to be under sections 509(a)(1) and 170(b)(1)(A)(iii) of the Code. In other instances, such as the operation of an old age home or skilled nursing facility, a similar approach would be appropriate for purposes of public charity classification under section 509(a)(2).

3. Joint Ventures Between Exempt Organizations

Rev. Rul. 98-15 addresses situations where an exempt hospital participates in a joint venture with a proprietary institution by contributing all of its operating assets. What about joint ventures between exempt organizations?

The Service recently approved the formation of a health care joint venture by several exempt organizations. The Service ruled that the joint venture activity would not jeopardize the tax exempt status or result in unrelated business taxable income to any of the organizations. The ruling distinguished that joint venture from those described in Rev. Rul. 98-15. See PLR 199913035 (Dec. 22, 1998).

A. The Facts

A is the exempt parent corporation of an exempt hospital system that includes two exempt hospitals and several other exempt organizations that provide health care and related services to the community, as well as some for-profit, taxable subsidiaries. B is a local

exempt hospital unrelated to A. A and B decided to combine their resources to expand the availability of health care to the indigent in the community. They formed a limited liability company ("LLC") to oversee and monitor the construction and operation of a Medical Campus, which would include a new hospital and ambulatory surgery center.

The LLC would be treated as a partnership for federal income tax purposes. B agreed to contribute \$25 million in cash to the LLC in exchange for its membership interest in the LLC. A agreed to contribute its stock interests in its for-profit subsidiaries as well as transfer the assets of the exempt subsidiaries to the LLC in exchange for its membership interest in the LLC. The anticipated value of A's contribution is \$100 million. Thus, A owns an 80 percent interest in the LLC, and B owns a 20 percent interest. A and B will be the only members of the LLC. B will be entitled to appoint 20 percent of the board members of the LLC, and A will appoint 80 percent of the board members. The LLC board will act by majority vote of its members, although certain actions will require the affirmative vote of a majority of A directors and the affirmative vote of a majority of B directors present. It is expected that the CEO and other senior management personnel of the LLC and of the exempt subsidiaries will be provided by A, and other management services as well.

The LLC's purposes specifically include carrying out the charitable missions of A and B, and to advance and support the health care needs of the community.

A will continue to provide funds and other assets to the exempt hospital subsidiaries and other exempt subsidiaries. All of the funds distributed from the LLC to A will be contributed back to or used for the benefit of the exempt entities. Also, A will continue to provide oversight through maintaining its own board by selecting 80 percent of LLC's board members. B will continue to provide its hospital community services and funds distributed from the LLC to B will be used in furtherance of B's exempt purposes.

B. Analysis

The ruling found that the charitable and exempt purposes of A, B and the exempt subsidiaries of A would be the same after the creation of the LLC as they were prior to it. The ruling noted that in contrast to Rev. Rul. 98-15, both members of the LLC are entities that are exempt from tax pursuant to IRC 501(c)(3), so that the activities of the LLC remain entirely in the control of the tax-exempt charities, and that the LLC would benefit only the exempt entities. The purposes of the LLC specifically include furthering the tax exempt purposes of its members and the exempt subsidiaries, and promoting the health and well-being of the community. The furtherance of these exempt purposes through the exempt hospitals and the other exempt subsidiaries will constitute substantially all of the activities of the LLC.

Thus, after the formation of the LLC, A, B, and each of the subsidiaries would continue to promote the health of the community and otherwise accomplish their respective exempt purposes through the operation of the LLC, consistent with Situation 1 of Rev. Rul. 98-15. Further, after the formation of the LLC, each of the exempt hospitals would continue to operate as a hospital and provide hospital care consistent with the community benefit standard described in Rev. Rul. 69-545.

The ruling determined that because A and B are exempt entities and because any income or cash of the LLC would be allocated as distributions only to A or B in accordance with the Operating Agreement, the creation and operation of the LLC would not result in any private inurement or private benefit.

After the creation of the LLC, A will continue to support its exempt hospitals and other exempt subsidiaries within the meaning of IRC 509(a)(3), based on the right of A to appoint approximately 80 percent of the members of the board of the LLC and the LLC in turn being the sole member of each exempt, nonstock entity. In accordance with the Operating Agreement, A will continue to provide management, supervision, monitoring, review, coordination and planning to its exempt hospital and other exempt subsidiaries each of which is a supported organization named in A's charter.

The ruling also found that to the extent that the for-profit subsidiaries engaged in a trade or business that is not related to the exempt purposes of A and the exempt subsidiaries, the size and extent of such unrelated trade or business is insignificant compared to the activities of A, B, and the exempt subsidiaries that are in furtherance of exempt purposes.

The ruling concluded the participation by A and B in the LLC would not constitute an unrelated trade or business to either of them within the meaning of IRC 513, and would not result in any of their respective assets being deemed unrelated debt-financed property under IRC 514. The exempt subsidiaries and hospitals will operate through the LLC in furtherance of exempt purposes, and these will constitute substantially all of activities of the LLC. The participation by A and B in the LLC will expand and improve health care services to the community. The LLC's corporate purposes require it to act in furtherance of its members' exempt purposes.

4. Update on Redlands Surgical Services, Inc. v. Commissioner

This is a case pending before the U.S. Tax Court regarding the petition by Redlands Surgical Services contesting the denial of its application for exemption under section 501(c)(3) of the Code. Tax Ct. Dkt. No. 11025-97X. Briefs were filed in March, 1998. Reply briefs were filed in May, 1998. Redlands Surgical Services v. Commissioner was discussed in the article on joint ventures in the 1999 CPE.

Redlands is a wholly owned nonprofit subsidiary of RHS Corp., the section 501(c)(3) parent of a hospital system. Redlands sole purpose and activity is to hold a partnership interest in a partnership that will control another (a second tier) partnership that operates a freestanding ambulatory surgery center. The other investor in the first tier partnership is SCA, a for-profit corporation that owns and operates ambulatory surgery centers. Redlands holds 46 percent and SCA 54 percent of this first tier partnership. That partnership in turn holds 59 percent as the sole general partner of the second tier partnership. Physicians on the medical staff of Redlands Community Hospital, a sister IRC 501(c)(3) organization, own 41 percent of the second-tier partnership as limited partners. SCA Management Company, a wholly-owned for-profit subsidiary of SCA has a 15 year management contract to operate the ambulatory surgery center, renewable at its sole option for two successive five-year periods, and it employs all non-physician personnel at the surgery center.

The Service maintained that Redlands was effectively a minority owner and had no meaningful control over the partnership. This indicates that Redlands is operated for a substantial nonexempt purpose through impermissible private benefit, thus precluding exemption. Moreover, Redlands does not manage the staff or control the facility and does not promote community health in a manner consistent with Rev. Rul. 69-545.

The Service further concluded that Redlands is not exempt as an integral part of Redlands Community Hospital or their joint parent because the activities Redlands performs would generate unrelated business taxable income if performed by either of them.

The Service based this conclusion on the following factors: the ambulatory surgery center provides little Medicaid care, operates like other ambulatory surgery centers as to profit and payor mix, provides no charity care, has no Medi-Cal provider agreement, and treats patients from anywhere, not just patients from Redlands Community Hospital. Thus, the Service determined that Redlands does not further the charitable purposes of its affiliates and found that there is no hospital or patient nexus with the ambulatory surgery center.